The development of financial reporting quality in Eastern European Union Countries in the aftermath of communism

Introduction and motivation

The 11 countries in the eastern EU have undergone enormous changes in the past two decades. They left behind authoritarian communist rule and became free democracies. Many of them engaged in nation-building, in those majority of cases where they had been Soviet republics or parts of larger nations. Finally, and as the subject of this paper, they abandoned centrally controlled socialism and adopted free markets. It is the purpose of this paper to study the development of financial reporting, a central element of successful market economies.

The central idea is that good financial reporting quality stems from good corporate governance. Good corporate governance is the result of good legal systems, in which the legal system consists of both written laws and good legal practice. Good legal practice has many dimensions: non-corrupt court systems, highly trained judges and lawyers, and strong institutions such as courts and regulatory agencies. It makes little sense to study accounting quality while ignoring the determinants of accounting quality. The common practice of including a dummy variable as an explanatory for accounting quality falls far short of understanding the linkages between the law and accounting.

This study traces the development of legal systems in those 11 eastern European Union countries. There were many historical developments that affected the quality of legal systems as they apply to financial reporting to shareholders. We trace some of those important transitional developments. In order to discover whether they had an effect on financial reporting, we perform empirical tests to measure "accounting quality."

The tests are based on the frequency of "small gains" relative to "small losses." This metric was introduced by Burgstahler and Dichev (1997). We attempt to improve on that metric and we introduce a new method of measurement.

Background

While there was some private property in those eastern European countries that were satellites or Soviet republics (Skapska 2009, pp. 294-5), there were no functioning stock markets and no large-scale private enterprises before the fall of the Iron Curtain in 1989.[1] The initial conditions were poor: "What the regime had left behind … was the atomized and politically decapitated mass of ex-clients of state socialism" (Elster et al. 1998). In this section we describe the major developments in Eastern Europe as they developed market economies.

The first step in the progress toward stock trading on exchanges with adequate protection for shareholders was privatization. Before having the capability of operating a free market, they had first to move assets from the state to the private sector. Voucher schemes were one popular approach that promised an equitable distribution, but other countries used other methods, such as selling state enterprises to foreign investors (e.g., Hungary, Greskovits 2006). This step preceded the development of western-style legal systems, so the rights and responsibilities of the new owners were poorly defined. A strong notion of responsibility to report to dispersed owners was still in the future.

The next phase was the development of laws in this area of company and contract law. This established the basis for a company's obligation to its shareholders and other investors. The World Bank (WB) played an important role. It disbursed development funds to most of these countries, and gave advice—sometimes even conditions—that went along with the money. This provided an impetus toward developing western-style laws and legal systems, specifically in a common law format. The WB and other legal scholars believed that this was the best path to development (Rubin 1994, Ajani 1995).

Later in the 1990s, these eastern European countries decided that their futures lay within the European Union (EU). This EU consisted mostly of civil law countries. These civil law countries' approaches to the law differed in several respects from the common-law guidance the eastern countries had been receiving from the WB. Civil law differs from common in important respects.

- Court decisions are based on finding the governing provisions within the code, with little room for the judicial discretion that characterizes common law (Hayek 1978).
- Different qualifications; judges enter the judiciary immediately from university, rather than practicing law for several years before becoming judges.

[1] Of the eleven eastern countries now in the EU, eight (Poland, Hungary, Czech Republic, Slovakia, Slovenia, Croatia, Romania, Bulgaria) were satellites of the USSR and were ruled by communist governments. Three (Latvia, Lithuania, Estonia) were republics within the USSR.

In the space of a few years these countries moved from communist law, to a law flavored with common law principles, to a civil law approach. This progression from no approach (due to non-existence of market-oriented infrastructure) to a common law approach to a civil law approach would have made a tradition of close adherence to sound principles of corporate governance (including reports to share owners) very slow and halting. One could not reasonably expect the best corporate governance from the point of view of the development of law.

The development of laws for free markets was not the only, or even the biggest task. For the following reasons, development of commercial law was slowed by more important matters. The development of law focused first on human rights (Sadurski 2004). Not only was it necessary for the countries to look forward in their legal systems, they had simultaneously to deal with their past. In the political aftermath of repressive governments, the countries were forced to address lustration laws, which specified what actions taken during communist rule former communist officials could be held accountable for. Rule of law could be applied as abiding by the law *in effect when the actions took place*; alternatively it could be the application of laws that protected human rights, even if those protections were not in the law at the time of the government officials' actions (Priban 2009). The task of modifying old and developing laws was complex and wide-ranging.

Further to complicate the transition in eastern Europe to western norms, consider that more than half of them were new countries. The Baltic republics were reconstituted to an earlier form, but had been for more than 40 years parts of the USSR. Czechoslovakia peacefully divided itself into the Czech Republic and the Slovak Republic in 1992. Slovenia and Croatia left the former Yugoslavia.

New laws are effective only if they are adhered to; they must be enforced and respected. That requires that citizens have confidence that the law will be applied evenly and fairly. There is evidence that regular courts (as distinct from constitutional courts) have performed poorly (Ganev 2009). The only country in this group where a majority of people thought the judiciary was not corrupt in 2005 was Estonia (Anderson and Gray, 2005). In 2003, after 14 years of democracy, only 7% of Poles believed that their fundamental democratic institutions worked well (Sadurski 2004). Table 1 reports one measure of the perceived quality of the legal systems.

The very notion of "transplanting" legal systems is problematic. Pierre Legrand (1997) describes the "impossibility" of transplants, while Alan Watson (1993) is fairly optimistic about the effectiveness of transplants. It is, at best, a challenge to import the legal system of another country that was developed in different social conditions. Pistor et al. (2002) show systematic differences between the "origin" countries (England, Germany, France) and the recipients of their transplanted laws. Siems (2007) maintains that laws do not survive the transplant unchanged.

In the context of markets, there is even more than passing new laws and implementing them. An important aspect of the free market system in the west is the independent securities regulator (e.g., Securities and Exchange Commission, Financial Services Authority). In the eastern countries with their communist past, the idea of an "independent" regulator, immune to political influence, was simply unthinkable (e.g., Pistor 2000).[2] Here was another obstacle to effective markets that went beyond passing and enforcing good laws.

Even with good laws, well enforced, with supporting institutions, there is the matter of capability. With the best of intentions, effective implementation of accounting standards is challenging. When the eastern EU countries acceded to the EU, they were required to adopt IFRS. This was more disruptive for the east than the west since all the western countries adopted at the same time, and furthermore those western countries were moving from national systems that had long anticipated the transition to IFRS (Walton 2009). In addition, they had a longer history of quality accounting and Big Four auditors.

In summary, the eastern countries did not simply glide from one legal system to another. The road has been rocky and hurdles have taken many forms. A system of law is complex. Even the human capital aspect is a hurdle; there were, after all, no civil law judges or lawyers under communism. The path to a corporate structure with good protection for investors was and is tortuous. This motivates the research questions: Have these companies finally reached the same high level as their western EU neighbors? Can we trace their progress?

[2] Priban (2009) makes the more general point that there was in general strong distrust of the state.

Hypothesis development

1. Cross-sectional cluster analysis

This section develops hypotheses to be tested cross-sectionally and others to be tested longtitudinally. This section argues that there are clusters of countries that are largely similar in regard to the legal and economic factors that influence financial reporting, and furthermore that there are important differences among the clusters that affect the quality of financial reporting. That is, the "within" differences are small relative to the "between" differences.

Cross-sectional differences in accounting quality can be expected because of the different historical and cultural traditions within eastern Europe. Ideally, hypotheses would relate to the unique legal conditions in each country, but these emerged only slowly, so company data are sparse in early years. It is true, however, that neighboring countries shared historical similarities that allow for analysis by clustering countries with similar legal and economic histories.

Baltic Republics First, these three countries (EST, LAT, LTU) were the only ones that were part of the USSR, and accordingly most firmly under the thumb of Stalinist communist law.[3] Second, as a result, they had no legal systems at all once they removed from the USSR. Third, they share a similar history as northern European countries, maritime nations, heavily influenced by German, and in the more distant past, Swedish domination and culture (Klinge 1995). Fourth, two of the nations are in the Eurozone and the other is part of ERM II; no other eastern countries have these characteristics.[4]

Visegrád group First, these four countries (HUN, POL, SVK, CZE), have the common attributes of being the most highly developed under communism, having the most sophisticated manufacturing capability (Bruszt and Greskovits 2009). Second, during the socialist era, they made the most serious deviations from "pure" communism (Ajani 1995). Thirdly, they are contiguous and share a heritage of the German legal family.

Table 2 shows that Poland dominates this sample. To the extent that this cluster is similar in its traditions and level of development, conclusions can be broadly generalized. The greater the differences between Poland and the others, the harder it is to generalize the results.

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[3] Socialist legal systems did contain characteristics of civil law; there has been some debate over whether socialist law is a separate legal family (Quigley 1989).

[4] ERM II is European Exchange Rate Mechanism II, a condition that is required for two years before adopting the euro.

Southern countries This is the group of countries (SVN, CRO, ROM, BUL) with, first of all, lower GDPs. Second, they have been influenced by the German legal tradition, but have also been influenced by Eastern Christian, Ottoman and French influence (Sacco 1989). Third they have been slower to develop, as they had not done as well under communism. Fourth the attitudes toward the law are less trusting (see table 1).[5] Fifth, they were the latest countries to join the EU, evidence that their legal institutions (and other factors) lagged those of their northern neighbors.

Based on the hypothesis that the rule of law is an important determinant of firms creating honest, compliant, comprehensive financial reports from managers to owners, the southern sample will have the lowest accounting quality. First, the perceived quality of the legal systems is lowest in these countries (table 1). Secondly, they were all occupied in their history by Turkey, so their laws were not so embedded in the western, German legal tradition as were the other groups. Third, they had not strayed far from communist principles at the time of the fall of the communist system, and had few precedents for a market system.

The Baltic republics will be in the middle. Because they were a part of the Soviet Union, they had little opportunity to adopt capitalist practices prior to the end of communism. They did have legal traditions that were formed by their Swedish and German histories, so the adoption of western laws was less of a historical departure than the southern group. Table 1 shows that their attitudes toward the law were more trusting than the southern group.

The Visegràd group was the most economically advanced during communism and significantly had a smattering of western-style laws (Hungary’s bankruptcy law was adopted in 1968, Poland’s agriculture was not thoroughly collectivized, etc.).

Based on the hypothesized linkage between the legal systems that form the foundation of corporate governance, the hypotheses about financial reporting quality are:

H1a: Accounting quality is better in Baltic republics than in the southern group.

H1b: Accounting quality is better in Visegràd countries than in the Baltic group.

[5] Although Croatia and Hungary are historically linked, Croatia and Slovenia were parts of Yugoslavia so their recent legal histories are similar.

Statistical methods

There is a wide array of measures of accounting quality. Many are based on accruals. These measures are problematic when—as is the case here—the various countries have different accrual rules (until 2005 when IFRS was applied). If any differences were detected, would they be due to the quality, or to the rules? A number of other quality measures use stock returns. The reliability of stock returns depends on efficient markets with synchronous trading. This is very questionable in a period when stock markets are just emerging.

One measure that is neutral with regard to the accounting rules is the "small gain, small loss" method developed by Burgstahler and Dichev (1997), that measures a disproportionate number of "small" gains relative to "small" losses. A large number of small gains cannot be a consequence of different rules.[6] This method, like all the others, has limitations, but it at least applies equally across different accounting systems.

Sample

The sample of firms is drawn from the Compustat Global data base. As shown in table 2, there are too few listed firms available in the 1995 data to perform any statistical analysis. There is an adequate sample from the later periods. Eliminating the smallest firms, those with sales less than $50 thousand, the number of firms in the study are in table 3.
This study compares conditions cross-sectionally and in time series

[6] Until recent years, financial reporting in Europe generally followed tax reporting rules. There would have been an incentive for managers to understate income in order to minimize tax. In this context, it would be a preference for a small loss over a small gain. This effect, if present, would reduce the likelihood of finding earnings management. If earnings management is detected, especially in early years of the sample period, the actual degree of earnings management is even greater than measured, if this effect is present.

Table 1: Factors that influence reporting to shareholders

Country	Trust in legal system (2010)
Bulgaria	16
Croatia	20
Czech Rep	34
Estonia	55
Hungary	53
Latvia	36
Lithuania	22
Poland	38
Romania	23
Slovak Rep	32
Slovenia	22

Notes: “Trust in the legal system” is the percentage of people who answer that they “tend to trust” the legal system. Source: Eurobarometer Interactive Search System. Date of survey: 11 2010. URL: http://ec.europa.eu/public_opinion/archives_en.htm

Table 2: Sample firms

		Number of firms		
Country	Cluster	2000	2005	2010
Bulgaria	Southern	0	4	11
Czech Republic	Visegràd	2	7	7
Estonia	Baltic	5	11	10
Croatia	Southern	3	13	29
Hungary	Visegràd	6	13	12
Lithuania	Baltic	1	22	22
Latvia	Baltic	1	4	5
Poland	Visegràd	40	122	247
Romania	Southern	0	10	29
Slovakia	Visegràd	2	4	3
Slovenia	Southern	6	16	15
Total		66	226	390

Note: The sample is limited to listed firms with sales greater than $50,000.